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The British Banking System: A good role model for Germany?

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List of abbreviations

AG	Aktiengesellschaft (incorporated German company)
AIM	Alternative Investment Market
CDFA	Community Development Finance Association
CDFI	Community Development Financial Institution
CRA	Community Reinvestment Act
DMI	Deutsches Mikrofinanz Institut (German Microfinance Institute)
DSGV	Deutscher Sparkassen-und Giroverband (German savings bank group)
DTI	Department of Trade and Industry
DZ-Bank	Deutsche Zentral-Genossenschaftsbank (second-tier institution for almost the whole co-operative banking sector in Germany)
ECB	European Central Bank
GLS	Gemeinschaftsbank für Leihen und Schenken (Community bank for Loans and Gifts)
HBOS	Halifax-Bank of Scotland
HSBC (F)	formerly known as Hong Kong and Shanghai Banking Corporation
IMF	International Monetary Fund
KfW	Formerly Kreditanstalt fûr Wiederaufbau (Germany's development bank)
MSEs	Micro and small enterprises
NCC	National Consumer Council
OFT	Office of Fair Trading
plc	UK public limited company
SMEs	Small and medium-sized enterprises
TSB	Trustee Savings Bank
West LB	Westdeutsche Landesbank (second-tier institution for the savings bank sector in North Rhine-Westphalia and Brandenburg
WGZ-Bank	Westdeutsche Genossenschafts-Zentralbank (second-tier institution for co-operative sector in the west of Germany)

Executive summary

- The British financial system is widely regarded to be more efficient than the German system. There is talk of the need to reform the German financial system. But is reform of the German banking system necessary, are there traits worth conserving and does the UK banking system provide a good role model?

- We tackle these questions by comparison of the supply of financial services to micro and small enterprises (MSEs) as well as to low-income households in the two countries.

- We find that the German public savings and mutual co-operative banks provide good payment services and access to finance to nearly all citizens, and serve the MSE sector well through their extensive regional and local branch networks. In contrast, there are serious access to payments services and finance issues in Britain, the Competition Commission has found a 'complex monopoly' in the provision of small business bank account services and there have been widespread branch closures.

- Furthermore, there seem to be fewer problems with over-indebted households in Germany than in Britain. The more widespread use of credit cards in Britain could be responsible for this. Aggressive marketing of these cards as well as excessively high penalty charges to credit card users who pay late, or are unable to clear their balances, contribute to the problem of over-indebtedness. The punitive charging in Britain is indicative of much more widespread cross-subsidisation in the provision of current accounts – high-balance, low-volume users generally cross-subsidise low-balance high-volume users due to low deposit interest payments and low charges (for those who stay within authorised credit limits, with punitive charges for those who do not, or cannot).

- The relatively high profitability of British banks in recent years may therefore owe much to exploitation of their 'complex monopoly' power. In contrast, the lower profitability of German banks is associated with a broader supply of financial services to small enterprises and low-income households. However, the *Sparkassen* (municipal savings banks) and co-operative banks, which are the most active banks in these market segments, have had an above average profitability in Germany. These findings should be borne in mind by advocates of increased concentration trying to shift the German system towards the British model.

- Public sector and co-operative savings banks are no longer a significant force in Britain, and indeed the government has been encouraging the development of Community Development Financial Institutions (CDFIs) and credit unions to fill the gap. Advocates of privatisation of the German public savings bank should also bear this in mind.

- If increased concentration in German banking can be shown to be necessary in order to achieve efficiency gains, then mergers involving the recently partially privatised Postbank and a (partial?) privatisation of the regional central banks of the savings bank sector (the *Landesbanken*) should be considered.

- There seems to be an inadequate supply of private equity to medium-sized enterprises and companies (the *Mittelstand*) in Germany, relative to Britain, and this is a gap that the large German ('private') banks, rather than the *Sparkassen* or the co-operative banks, might naturally try to fill (in competition with other European banks, private equity and venture funds).

1 Introduction

The German financial system is a prototype of a bank-based system. In the 1980s, this was considered an important pillar of Germany's economic strength. However, this perception seems to have radically changed. Nowadays, Germany is characterised as being overbanked and its banking system inefficient (relatively high cost), not particularly profitable and in need of radical restructuring.[1] Furthermore, Germany's capital markets are considered to be underdeveloped, leading to a lack of access to equity finance, especially for young, innovative firms. Although, in the 1990s, there was a strong political push to initiate change towards a more capital market-based system, the main features of the German financial system seem to have persisted (Hackethal and Schmidt, 2005). At the same time, however, international competitive pressure in the banking market has increased, giving rise to new political concern. Could competition in the banking sector undermine the supply of financial services to small and medium-sized enterprises (SMEs), which has always been considered to have performed well by the German '*Hausbanken*'?[2]

Given this background, we ask whether the British financial system could be a good role model for Germany. Britain is often cited as a prototype of a market-based system. Accordingly, firms' access to securities markets is well developed. Furthermore, the British banking system has an international reputation for being profitable and efficient (relatively low cost), and at first sight this appears to be the case. If there are obvious shortcomings compared to Germany, they are most likely to be found in restricted access to financial services for small customers – be they firms or private individuals.

Financial exclusion can, however, be interpreted in two different ways. One possibility is that excluded customers cannot be served by private sector banks in a cost-covering and profitable manner, and, consequently, the supply of financial services to the target group of small firms and low-income households is a public and social responsibility. Alternatively, British banks do not serve these customers because there are market inefficiencies. Accordingly, the UK banks' high profit figures and low branch density would not be the reflection of efficient service, but indicative of market inefficiencies, resulting from monopolistic practices.

How access to financial services for the smallest customers is organised in Germany, and, furthermore, whether and why there is financial exclusion of the comparable customer segment in Britain, are the questions to be addressed in this report. The answers to these questions seem of utmost importance for the overriding problem of whether Britain can provide a good role model for Germany, or whether it could be Germany that provides the better model – at least, where the supply of financial services to small customers is concerned.

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[1] These stereotypes are robustly challenged by the Deutscher Sparkassen-und Giroverband (DSGV), the German savings bank group in two recent papers (DSGV, 2005a, 2005b).

[2] The '*Hausbanken'* are the 'house' or main banks or firms.

The findings of the report are based on desk research, conference attendance and a series of interviews (see Appendix). The rest of the report is organised as follows: Chapters 2 and 3 give a brief outline of the German and then the British banking systems with a special focus on who is supplying financial services to small customers; by comparing the features of the German and British systems, Chapter 4 draws tentative conclusions; Chapter 5 sums up and points to open questions for future research.

2 The German banking system in outline

Germany's three-pillar commercial banking system

Germany's commercial banking system is subdivided into three different sectors:

- the savings bank sector (public banks), consisting of about 460 municipal savings banks (*Sparkassen*) and 11 *Landesbanken*, owned by the savings banks and the state (*Länder*) governments.
- the co-operative banking sector, consisting of over 1,300 local co-operative banks and 2 central, over-regional institutes (DZ-Bank AG, WGZ-Bank eG), and
- the group of private, for-profit banks (*Kreditbanken*)[3], consisting of 252 institutes, including 84 branches of foreign banks, 164 regional and other banks as well as the four big private sector banks (*Großbanken*), Deutsche Bank AG, Dresdner Bank AG, HypoVereinsbank AG and Commerzbank AG. In 2004, the 'Deutsche Postbank', formerly 100% owned by the Deutsche Post, was partially privatised and became the fifth 'big bank'.

Market shares – figures based on 2004 data

In considering our research question, the first two groups plus the Postbank are the most interesting market players – a view easily backed up by some facts about market shares. The 'big four' German 'private' banks (excluding the Postbank) have a market share of about 16% by balance sheet size and less than 10% of savings deposits, while the 'public' savings banks (*Sparkassen*) and the co-operative banking sector combined have around 80% (approximately 50% savings banks and 30% co-operative banks) of deposits and account for over 45% (approximately 36% savings banks and 12% co-operative banks) of the aggregate balance sheet of the banking system (Deutsche Bundesbank statistics).

Taking into account the fact that the savings banks and the co-operative banks each have more than 15,000 bank outlets and thereby represent almost 80% of all banking outlets (excluding the Postbank), it is obvious that these two groups are the main suppliers of financial services to small customers. A 'new player' challenging this position is the Deutsche Postbank, which offers its – formerly restricted, but now fully fledged – financial services in more than 14,000 postal offices. Internet banking is not likely to change this picture drastically, although some direct banks are gaining market share with those customers who exclusively use the internet for their financial transactions.

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[3] Figures based on 2004 data.

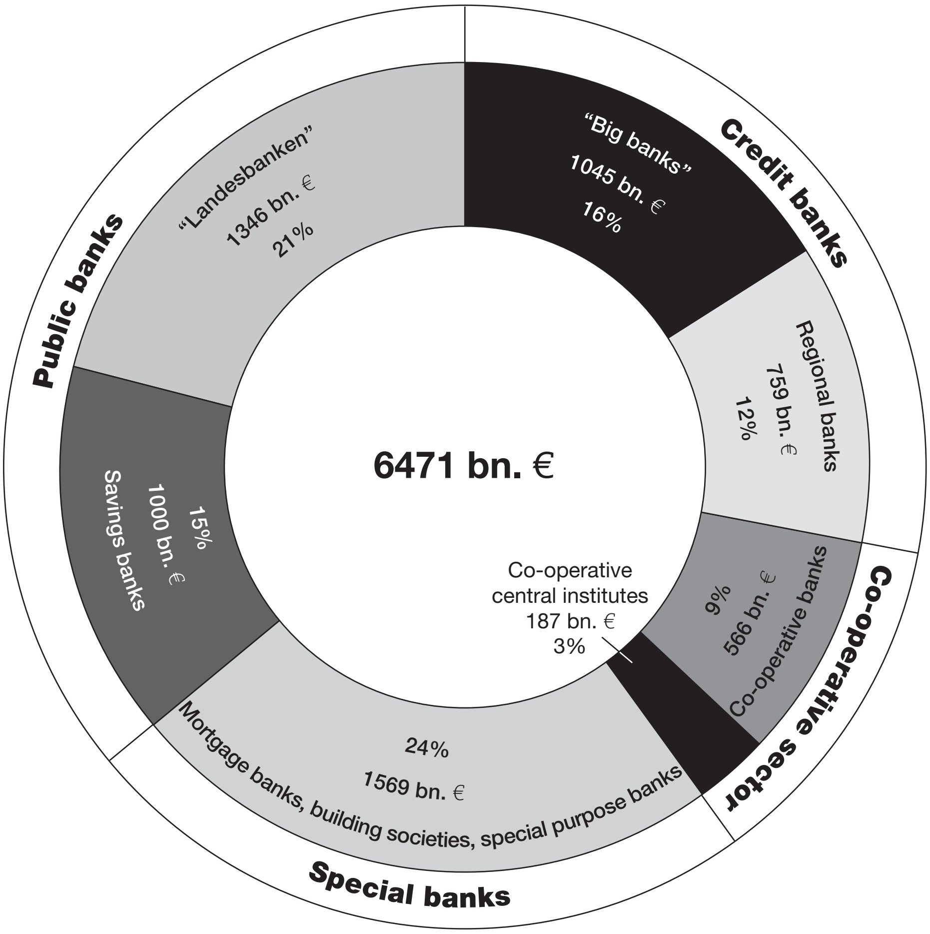

Figure 1
Structure of the German Banking System according to Banking Groups

Notes:
1. Total assets – in-country-business – end 2003.
2. Regional banks include other banks and branches of foreign banks.
Source: Sachverständigenrat, 2004.

The figures on current accounts reflect the strong market position of the *Sparkassen*, co-operative banks and the Postbank in retail banking. In Germany, almost every private individual has at least one current account (94% of all individuals over the age of 14). The *Sparkassen* sector has just above 40 million current accounts, which is at least a third of the market. The co-operative banking sector has about 30million customers and the Postbank's number of accounts is growing fast, reaching over 12million current accounts by the end of 2004. It should be mentioned here, however, that even these banks were reluctant to open bank accounts for lowest income individuals – for example, those on social security. The savings banks needed to be reminded by their public owners of their social responsibility before they accepted such 'unattractive' customers.[4]

[4] In 1995, the banking industry endorsed voluntarily a joint recommendation, the 'Girokonto fûr Jedermann' (Current account for everybody: no overdraft facility). The county court of Berlin ruled in 2003 that this recommendation constitutes a claim for the opening of a current account. The county court of Bremen ruled in 2005 that this claim is even substantiated if solvency proceedings have been initiated against the respective customer, there have been garnishments or the customer has made overdrafts contrary to the contract.

We can therefore conclude that the German banking system guarantees open access to the most basic banking services – for example, the payment service – for all population groups, including very small, low-income customers and even juveniles without an independent income. People have easy access to local banks throughout the country, and enjoy an efficient, paperless (cheques are hardly ever used) giro payments system and seem willing to pay monthly or annual bank charges (almost all banks offer special or even zero rates for juveniles and students) for the services provided and used.

Loan supply

Taking a look at a more sophisticated financial service – the supply of loans to small customers and especially to small firms – we find a similar hierarchy of bank service provision. The big four banks have not historically competed at the local level and indeed a sort of 'pecking order' arrangement has historically prevailed. Deutsche Bank has serviced the largest corporates and HypoVereinsbank, Commerzbank and Dresdner Bank the next largest, while MSEs, including the broadly defined *Mittelstand* (incorporating what would be regarded as both medium-sized enterprises and medium-sized companies ['small caps', etc.] in the UK) have tended to be served by the savings and co-operative banks, or regional 'private' banks. If a local *Sparkassen* or co-operative bank is too small to provide bigger firms with an adequate service, it can refer these customers to the respective central institutes – the *Landesbanken*, DZ-Bank or WGZ-Bank, which have the size to be internationally present and even to compete with the 'big four'.

It is therefore the savings and co-operative banks which serve the MSEs, with the larger banks showing little interest. Our interviews (see Appendix) revealed that *Sparkassen* frequently receive referrals of such enterprises from the big 'private' banks – a trend which has been reinforced in recent years in expectation of the new international banking regulations (Basel II) and the general economic downturn in Germany. It is well documented that the big banks became more restrictive in lending to small enterprise customers in the early 2000s. At the same time, the savings bank sector gained market shares in lending to enterprise and self-employed people (from 38% in 1999 to 42% in 2003). Furthermore, the Postbank, which traditionally did not offer loans, is now trying to enter the loan market, with an emphasis on consumer loans and overdrafts; however, its loan business with MSE customers is clearly underdeveloped as yet.

However, for very small firms and self-employed people, it is almost impossible to draw a clear-cut line between consumer and business finance. Thus, access to household retail banking services may also be important for MSEs, and indeed the *Sparkassen* use information gained from operating such accounts to screen small-business loan applications. Our interviews further suggest that, in Germany, MSEs are beginning to use consumer credit (for example, credit cards and current account overdrafts) to provide working capital and even investment capital (for example, computers and printers), and car loans to buy a vehicle for the business. Credit cards have become increasingly popular in Germany, but the majority of them are issued by the domestic banks and tend to operate as 'charge cards' with the credit balance paid off automatically at the end of each month. Customers wishing to carry credit forward have to arrange a loan. Foreign banks (Citibank inter alia) are offering UK-style credit cards (where only a minimum balance needs to be paid monthly and the remaining balance is carried forward with interest being paid on it), and there is a growing market for them. The big four German banks seem likely to enter this market; but it is unlikely that they will try to serve the small customers.

It seems safe to conclude that the local *Sparkassen* and the co-operative banks – with growing competition from the Postbank – hold the majority of the bank loan business with small customers, be they private individuals or firms. Consumer credit from non-banking sources is growing in importance, but not as much as in other countries. That the problem of over-indebted households is much less pronounced in Germany than in the UK might be a reflection of this market trend, as well the ethos of these banks, which are the main providers of financial services to small customers. Certainly, it must not be forgotten that none of them are fully fledged 'for-profit' players.

The strong role of non-profit banks in Germany

The Postbank is a spin-off of the Deutsche Post, a German state-owned enterprise; but, although it was partially privatised, the Deutsche Post remains its main shareholder. The Postbank can offer financial services through Deutsche Post's branching network, which can be valued as a competitive advantage, smoothing its entry into the commercial financial market. It is not yet fully commercialised, or a full service bank.

The co-operative banks are purely private banks, but with a non-profit mission to support the business of co-operative members. Although co-operative banks have long adapted their service profile and business policy to that of other banks,[5] co-operative banks still have competitive advantages. One is a result of their governance structure. Co-operative banks do not pay dividends on accumulated reserves, and members have to leave their reserves behind if they resign their membership. Accordingly, equity cost is comparatively low. Second, co-operative banks, as well as local *Sparkassen*, enjoy a regional monopoly within their own organisation. Third, although tax advantages have long been abolished, co-operative banks still enjoy the privilege that part of the members' personal liability for the debts of the bank is recognised as regulatory bank capital.

The most important competitive advantages have been enjoyed by the savings bank sector, however. The whole sector, including those huge *Landesbanken* such as the Westdeutsche Landesbank (West LB), whose size is comparable to the *Großbanken*, is publicly owned. Germany, along with Finland, is the country with the highest percentage of state-owned banks in the whole of Europe. Their ownership structure does not exempt savings banks from commercial aims, but they also have a public mission. Besides being the *Hausbank* of their owner, the local municipality or the state, *Sparkassen* are required to offer banking services, especially loans, to the regional economy, and to provide financial access to broad classes of the population. In exchange for fulfilling this public mission, the public owner provided these banks with a two-fold guarantee: the public owner was unrestrictedly liable for all debts of the bank in the event of default (*Gewährträgerhaftung*). Furthermore, the public owner had a so-called maintenance

[5] Since the beginning of the 1970s, for example, they have offered loans to non-members.

obligation (*Anstaltslast*), which made the public entity responsible for equipping its bank in such a way that it could perform its business. Accordingly, banks belonging to the savings bank sector enjoyed excellent ratings and low refinancing costs when raising subordinated debts to strengthen their regulatory capital. Big savings banks and *Landesbanken* even tapped international financial markets.

The EU's competition commissioner concluded that these competitive advantages were unjustified market distortions, and required the public guarantee to be abolished in July 2005. However, as our interview partners revealed, the savings bank sector prepared well for this event in the intervening years by covering in advance its refinancing needs for the immediate future. The reason for this is simple: all financial resources raised before the cessation of the guarantee are still covered by the unrestricted liability of the owner, no matter when these debts mature. Accordingly, it will be a rather long transition period before the long-term effects of the abolition of public guarantees will become apparent. Furthermore, the regional monopoly of each local *Sparkassen* within its organisation will stay untouched in the future.

It is the non-profit savings banks and the co-operative banks, along with the Deutsche Post, which are responsible for Germany's having the least concentrated banking system in Europe with an extremely high density of branches in worldwide comparison (Hackethal and Schmidt, 2005).[6] No doubt, this structure has its advantages: there is very good access to financial services for the whole population, not least small enterprises. But this advantage may have a cost. Could the prominent role of non-profit players have caused distortions and inefficiencies which are responsible for the bad ratings of German banks in respect to their profitability?

Efficiency and profitability of German banks

Without doubt, high branch density will cause high fixed costs, which could be one reason for the income-cost ratio of German banks being on average substantially higher than in other European countries and the US. The return on equity of German banks lags even further. The average return on equity of all German banks was as low as 0.7% in 2003 (EU: 5.9%; UK: 11.1%; US: 10%, see Bikker and Bos, 2004) although the latest figures (October 2005) show a remarkable rebound (largely due to investment banking business) at Deutsche Bank.

These facts and figures for the early 2000s have contributed to a rather negative view of the German banking system and international pressure for the big German banks, first of all Deutsche Bank, to justify their new business policy by giving priority to shareholder value, which was formerly unknown in the stakeholder-oriented governance structure of Germany. Even the International Monetary Fund (IMF), in its financial stability assessment report on Germany in 2003, argue that a restructuring of the three-pillar system is necessary, especially concerning the big public banking sector banks (IMF, 2003).

[6] But, it should be recalled that the branch figure is inflated by inclusion of the post offices (see reference in Footnote 1).

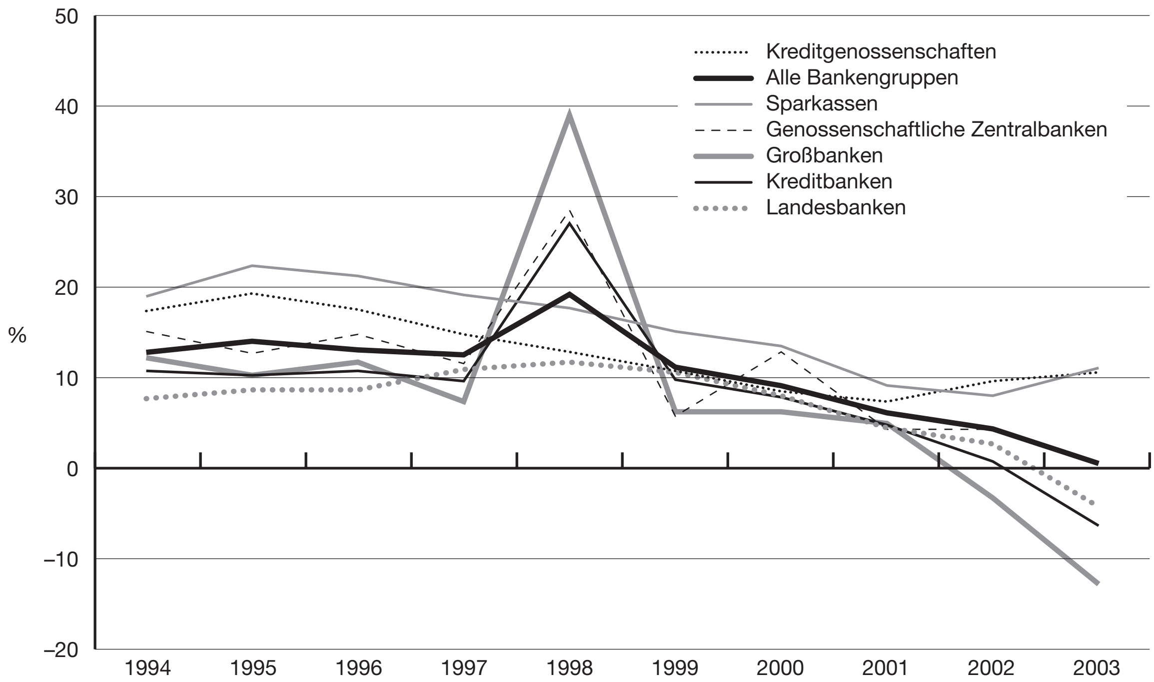

Figure 2
Return on equity before taxes of German Banking Groups 1994–2003

Note: Profit before taxes divided by average balance sheet equity.
Source: Sachverständigenrat, (2004).

Other authors dispute these views. Brunner (2004) argues that the bad situation of the German banks is more due to the stagnating German economy than to inefficiencies in the banking sector. Also, Hackethal and Schmidt (2005) do not agree with the pessimistic view of the IMF. They highlight the marked stability of the German system and its significant role in the German economy. The defenders of the German banking system find some support in the facts and figures as well. Many financial experts are surprised by the finding that the German local savings banks, as well as the co-operative banks, can boast of extended financial performance which is well above all the private banks except during the investment banking boom in the late 1990s, which boosted the returns of the *Großbanken*. They in turn suffered badly following the collapse of the dot-com bubble and were forced to re-focus on neglected domestic commercial banking opportunities as a consequence.

The *Sparkassen* and co-operative banks are seemingly more ‘profitable’, even though they serve smaller customers. Is there therefore a way to fulfil a social mission without having to pay for it? Or, is the performance of these banks the result of their (now reduced) competitive advantages causing negative external effects on their for-profit competitors?

Furthermore, if these non-profit banks reach down to the smallest customers, why does the German government still feel obliged to launch special programmes to support MSEs?

A closer look at the financial system of the UK might help us move closer to answering these questions.

3 The situation in the UK

British commercial banks as for-profit market players

Most British banks are profit-seeking organisations. Some of the mutual savings bank sector remains – namely, Nationwide and other building societies – and the Co-operative Bank plc does have a social and environmentally responsible investment (lending) ethos. However, these institutions do not play an important role in the banking market.

As profit seekers, one might argue that the British banks should be free to formulate their own attitudes to their social responsibility, and that they should not be obliged to perform public tasks (Hellwig, 1999). Their main obligation is to perform as financial intermediaries and to support the allocation of scarce resources to their best use. If profitability is an adequate indicator, British banks perform well. With a return on equity of over 12%, they belong to the top performers in Europe. It cannot be ruled out, however, that high profits are not purely a sign of efficiency. As mentioned before, monopolistic practices might be at work as well. One branch of the banking business where this might be the case is the supply of payments services.

The payments system as a natural monopoly

British banks' dominance of the payments system remains despite their agreeing, somewhat reluctantly (Mullineux 1987, Chapter 2), to open up to outsiders and set up the Association of Payments Clearing Systems (APACS). Payments systems themselves are akin to natural monopolies with room for only single systems to operate at efficient scale (lowest costs), and this is reinforced by their network character. As natural monopolies, payments systems are like the railways, or the electricity or gas supply networks. It is not sensible to have parallel railways, or electricity cables, gas pipelines, or grids. Payments systems resemble a telephone network. The benefits of participating increase with usage and membership, as with the widespread acceptance of credit and debit cards.

In other words, there is a public utility and infrastructural character to payments and related basic banking services. Most other natural monopolies and networks in Britain are regulated to ensure that monopolistic power is not exploited and that there is competitive access – although this is taking longer to achieve with the fixed line telephone networks than with gas or electricity, and it may not be working so well with the railways where short-term local monopolisation of certain routes seems to prevail between licensing rounds.

A series of reports on the British payments system (National Board for Prices and Incomes, 1967; National Consumer Council [NCC] 1983; Price Commission, 1978; Wilson, 1980) concluded that the payments system was indeed a natural monopoly, infrastructural and had public utility aspects, but that the banks were not abusing their market power.[7] The NCC report did, however, suggest that the banks might be restricting entry. More recently, the 'Cruickshank Report' (2000) concluded that, despite the establishment of the Association of Payment Clearing Systems (APACS), the banks were operating 'complex monopoly'[8] in the supply of payments services to SMEs, and recommended inter alia the establishment of 'Payco' to regulate the payments system, and particularly charges for use and entry, in the manner that the gas, electricity, rail and telephone networks are regulated.

Five years later, Mr Cruickshank has been complaining in the press that there has been little action except the setting up of a Review Committee staffed primarily by bankers. He suggests that senior civil servants have blocked his proposals for fear of introducing competition and reducing profitability and stability in the banking system, and therefore putting the payments system at risk.

It has long been held (see, for example, Revell, 1975) that too much competition, by reducing profit margins and thus quick fixes to pressures on capital ratios, could undermine banking stability. But usually, if regulators are worried about excessive competition, it is not in the payments system, whose benefits increase with usage, but because eroding margins in the credit business reduce the custom of retained revenue profits. Accordingly, monopolistic practices in the supply of payment services, which might lead to the exclusion of small business and lower income households, does not seem acceptable, all the more as payments services are the most basic of banking services and provide the point of entry to more complex banking services like credit products.

That does not mean, however, that the potential problem of excessive risk taking should be ignored. To provide incentives for adequate provisions against risk, banks used to be allowed in a number of countries, including Germany, to hold hidden reserves. Such views seem out of place in the days of Basel II risk-related capital adequacy requirements, greater disclosure and accounting transparency, and pro-active provisioning against bad and doubtful debts. Nevertheless, a problem of excessive risk taking might still remain as the big five UK banks (HSBC, Royal Bank of Scotland/NatWest, HBOS, Lloyds TSB and Barclays) are too big to be allowed to fail without causing major disruption to commerce.

To the extent that the big British banks feel that the Treasury (and the Bank of England) is protective, there might be a moral hazard issue (banks may take on too much risk). However, excessive risk taking would put banks' charter value at risk, and, furthermore, Basel II should hopefully curb moral hazard as well. Further, if the Treasury expected banks to display heightened concern for small customers in return for the protection, something seems to have gone wrong with this implicit contract – perhaps because the big banks now argue that they are competing in a European single market for financial services or a globalised market. That may be the case, and British banks seem to be doing rather well. Nevertheless, retail banking systems worldwide remain localised with potential for local monopoly, and the British banks seem to enjoy a local (i.e. UK) monopoly in the provision of banking services to SMEs.

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[7] See Mullineux, 1987, Chapter 2, for further discussion.

[8] A 'complex monopoly' situation, in relation to the supply of (banking) services in the UK, exists when at least one quarter of the services supplied (by a group of banks in this case) are supplied in such a way that prevents, restrains or distorts competition. Further details can be found in Section 7 (2) of the UK's Fair Trading Act.

Prior to the Cruickshank Report (2000), in the early 1990s, the Treasury and the Bank of England (see Bank of England, 1994–2004) responded to complaints from small business that, as monetary policy was eased, the banks were failing to pass through interest reductions to loans, and that there was increased credit rationing.

The 'complex monopoly'[9] in SME banking

A joint Bank-Treasury review in the 1990s led to the Bank of England's agreeing to keep bank-lending practices to small businesses under review. The department in the bank undertaking the review produced a series of annual and special reports (Bank of England 1994 to 2004) but has recently been closed, presumably because it is believed to have done its job. The more recent reports broadly concluded that substantial progress had been made in bank SME financing practices since the early 1990s.

This sits oddly beside the post-Cruickshank Competition Commission Report (2002), which confirmed the existence of a 'complex monopoly' in the provision of business current accounts to SMEs and imposed a rather odd pricing structure[10], which actively encourages cross-subsidisation and, thereby, facilitates tax avoidance. A recent academic study by Heffernan (2005) confirms evidence of a 'complex oligopoly' in the provision of bank services for small businesses and highlights the arbitrary nature of the Competition Commission's '2.5% rule'[11], observing that banks could compensate for any lost revenue by raising their (complex) service charges or loan rates, or cutting deposit rates.

Cross-subsidisation

The existence of cross-subsidisation is rarely associated with efficient practices. In British banking it arose out of non-price (i.e. non-interest rate) competition (see Mullineux, 1987, Chapter 2), whereby banks progressively competed by offering free (from fees) bank accounts – first with positive minimum balance requirements, then zero minimum balance requirements; and first with zero interest, and then positive interest on positive balances. Since then, the big banks have been pairing back interest offered and increasing fees, presenting some competitive pricing opportunities to smaller banks. Inefficiency arises because relatively high-balance, low-payments service users ('old ladies') cross-subsidise high-payment, low-balance users ('young professionals'). In addition, the UK competition authorities seem increasingly to be coming to the view that 'normal' charges are generally

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[9] See Footnote 8.

[10] Banks are required either to pay credit interest on SME accounts of at least Bank of England bank rate less 2.5%, or to make no charges for the main money transmission services (or to offer a choice between the two). They have generally chosen to credit interest (with Barclays the exception in offering a choice), leaving themselves free to set charges as they wish (Bank of England, 2003).

[11] See Footnote 10.

held down as a result of revenue derived from 'punitive' charges for late payments on credit cards or temporarily exceeding overdraft limits.

The young professionals also avoid the tax they would pay if they had earned wholesale money market-related interest rates and paid fully for their payments service usage. In other words, implicit interest is being paid as a result of not fully recovering the costs (with a suitable margin for return on capital invested) of payment service usage, at a cost to the rest of the public in the form of lost tax revenue. Further, excessive use of payments services is being encouraged by underpricing. In the past, this slowed the switch from less efficient paper-based payments (cheques) to electronic payments using debit cards (Mullineux 1987, Chapter 3). To the extent that 'Chip and Pin' reduces transactions costs, this should be reflected in the fees charged to account holders, thereby providing additional incentives to reluctant (generally older) adopters.

Financial exclusion

The Bank of England (2000) confirmed the existence of financial exclusion in deprived communities following on from the influential 'Small is Bankable' Rowntree Research Report by Mayo et al (1998). Further, in the late 1990s, there was a public outcry, especially in rural areas, about the closure by big banks of non-profitable branches. The banks were forced to scale back their closure plans somewhat, but subsequently there have also been Post Office branch closures, partly due to pressure for them to make a profit. The profitability of Post Office branches was made more precarious by the government decision to make social security payments through bank accounts. Prior to imposing that, however, it was of course necessary for citizens to have accounts into which giro payments could be made. In 2000, however, a significant percentage of British people did not have a bank account. The government's solution was to encourage banks to offer 'basic bank accounts' providing payments services and accepting deposits (but not offering loans or overdrafts) through Post Offices (partially offsetting their loss of social security disbursement business, and associated trade), or their own branches. This seems to have worked fairly well, although many 'high streets' still have at least one shop offering to cash cheques for a fee, and many banks have opted to offer the 'basic banking' services only through Post Office branches and not through their own branches.

Access to finance, credit cards and over-indebtedness

For the poorest and most geographically remote members of the public, there therefore remains an issue of access to the payments system and wider banking services. Internet banking can help overcome remoteness, as in Scandinavia, but the aged and the rural and urban poor remain excluded. Deprived communities thus face financial exclusion, and there are more general access to finance issues. Credit and loans are not available from the big banks, and insurance of possessions is also impossible or very expensive to purchase for those who live in 'red-lined' areas – i.e. having the wrong postal code. The poor, in other words, either have little or no access to finance, or can only purchase it at much higher cost (from 'loan sharks' and other 'sub-prime market' lenders, for example) than the rich.

Additionally, despite growing evidence of over-indebtedness in the UK, Datamonitor announced on 21 July 2005 the findings of research that showed that there remained untapped profitable opportunities in 'non-standard credit card lending' – i.e. lending to 'sub-prime' or credit agency 'black-listed' clients who would be willing to pay premium interest rates on credit card debt.

This is a similar market to that traditionally served by 'doorstep lenders' in the UK (for example, Cattles – see *Financial Times*, 20/7/05). Such companies traditionally offer credit (and collection of repayments) on the doorstep, and in the 2000s were under investigation by the Office of Fair Trading (OFT) following a 'super complaint' by the NCC, another UK consumer watchdog, about their high interest rates and 'predatory lending' practices. Cattles had just set up modern offices near Nottingham to provide consumer finance (for example, car loans) to 'sub-prime' customers who had been turned down by other lenders. The Financial Times article suggests that Cattles and other 'doorstep lenders' have been squeezed out of their traditional market, in which they competed with small money lenders and pawnbrokers, by the increasing access of their traditional customers, who live on run-down inner-city housing estates, to credit cards.

Further underlining the similarities between 'doorstep lending' and the issuance of credit cards to 'sub-prime' clients, the OFT has threatened (*Financial Times*, 27/7/05, p 4) to impose price controls on credit card issuers (mainly banks in the UK), which continue to charge penalty fees to late payers and those who exceed credit limits that the OFT and 'Which?', the UK consumer watchdog, regard as excessive or 'punitive'. In reality, the vast majority of UK credit card holders (96%) choose to pay off, using a 'Direct Debit', the full balance on a monthly basis. This is in line with the German practice, and the proportion is rising in the UK. So too is the use of debit cards for purchases, which now exceed those with credit cards and are growing faster (see *Financial Times*, 05/5/05, p 4). Another large proportion of credit-card holders normally pay the full balance at the end of most months, only carrying forward credit after holidays, Christmas and the like, using credit cards to 'smooth' consumption expenditure.

It is therefore a relatively small proportion, of sometimes multiple credit-card holders, who accumulate debts. This raises the possibility that UK credit-card issuers are engaging in irresponsible, and possibly predatory, lending. It is thus also likely that those who succumb to the temptation, or are driven by personal circumstances to take the opportunity to overborrow, end up paying the 'excessive' fees and charges. In so doing, they increase the revenue of the card issuers, allowing them to reduce fees or interest rates charged to more fortunate and wealthy users, who can choose to enjoy free credit as a consequence. In other words, we have yet another example of cross-subsidisation within the fee structures of UK banking.

Ironically, a Financial Times article (27/7/05, p 4) reporting on the OFT concerns about 'excessive' or 'punitive' penalty charges on credit cards contained within it a shorter article on a Birmingham-based 'loan shark', who had developed a 'consumer credit' business without a licence. He was alleged to have 'preyed' on vulnerable consumers by taking social security books and national insurance numbers as 'security' and charging exorbitant interest rates. In addition, the Court of Appeal was considering a case, brought by a licensed consumer-credit firm (Northern Securities), that the Liverpool County Court had judged to have engaged in extortionate lending and instructed to write off a debt. The appeal was subsequently rejected and the debt had to be written off – i.e. the allegation of extortionate lending was upheld.

All these incidences provide evidence that there is a 'commercial market' for loans to low-income households which, however, is not served by traditional bank loans. It rather seems to be non-bank consumer lenders and credit-card issuers who serve this market. Obviously, they would not supply these loans if the business was unprofitable. Charging high interest rates might be necessary to cover the risk of lending to the 'sub-prime' customer group, but there seems to be some cross-subsidisation involved. Furthermore, the majority of the customers who pay the high premiums are lacking financial knowledge and belong to the socially most vulnerable part of the population. Therefore, the existence of this loan market for poorer households might not be a purely positive phenomenon, offering the service of consumption smoothing to those who are excluded from the banks' loan market. The existing loan market for the poor could well be contributing to the social problem of over-indebtedness at the same time, the cost of which has to be carried at least partly by society as a whole.

The Bank and the Treasury, having acknowledged the access to finance problems, have not pressed the banks to fulfil their public and social duties directly. Instead, the idea of social banking provided by special non-profit financial institutions has been reintroduced in the UK financial system.

Social banking and access to finance

There is no public sector or co-operative banking sector with a social mission in the UK comparable to that in the German system, although the UK Post Office now offers basic banking services, following government intervention. Non-profit institutions did exist, however, but they almost disappeared from the market.

The UK municipal banks have long been absorbed into the Trustee Savings Bank (TSB) network, which was subsequently taken over by Lloyds Bank to form Lloyds TSB. Furthermore, a notable feature of the British banking system has been the erosion of the mutual savings bank (trustee savings banks and building society) sectors. The Post Office developed the Girobank in the 1980s, which was sold off in the 1990s to Alliance and Leicester, a former building society that had 'de-mutualised' (converted from a mutually owned society to a public limited company). Many other building societies, which traditionally took savings deposits and offered home loans, also de-mutualised in the 1980s and early 1990s; these included the two largest societies with nationwide branch networks – Halifax and Abbey National. Nationwide, formerly the third largest building society, is the remaining mutual building society with a truly nationwide retail banking reach, but numerous smaller and regional societies remain. Following permissive legislation, all building societies were allowed to diversify into retail banking and thus to provide current accounts and home and other loans, and the larger ones have been given permission to engage in SME lending. However, few have taken the opportunity to enter that market aggressively.

New mutuals, such as credit unions, have not been able to fill the gap. The largest credit unions are work-, not community-, based, and therefore do not serve the poor. A recent study by the Woodstock Institute (Malcolm Bush et al, 2002) points to a similar picture in the US – namely, that the credit unions do not serve the very poor but instead commonly provide cheap basic banking for the middle-income groups to whom banks would not expect to cross-sell substantial amounts of insurance and pensions products.

Nowadays, when non-profit and social banking has almost disappeared from the UK banking market, this seems to be considered a shortcoming as public initiatives are taken to support the set-up establishment of a new type of social banking institution: the Treasury, with the help of the Department of Trade and Industry (DTI), has encouraged the establishment of Community Development Financial Institutions (CDFIs).[12]

Copisarow (2004) concludes that it has done so with some success, using the Phoenix Fund to provide capital to help the CDFIs gear up and tax incentives to banks and others who supply capital to CDFIs.[13] The Phoenix Fund is now closed, but other funds to promote smaller loans are now being provided via Regional Development Agencies – for example, Advantage West Midlands' new Small Loan Programme.

The role of CDFIs

The aim is for the CDFIs to fill the gaps the banks have chosen to leave, and to do it more cheaply than banks could. It is hoped that banks, in supplying capital and perhaps also back-office support, will enter into partnerships with CDFIs with the prospect of gaining referrals of the businesses that thrive and thereby become 'bankable'. The CDFIs can also potentially provide a conduit for the pre and post start-up business advice and training provided by the DTI's Small Business Service. An influential model for the UK CDFI system is Chicago, where CDFIs have long been established and receive some sponsorship for training and also loan guarantees from targeted US Small Business Association programmes. In line with the US, the UK CDFI movement has established an association to represent its interests and facilitate the sharing of best practices – the Community Development Finance Association (CDFA).

It is notable that, apart from the US, most other countries have not felt the need to establish special new institutions to fill gaps resulting from their banking systems' choice not to provide banking services to 'unprofitable' clients, or as a result of branch closures. Wealthier clients offer much better opportunities for cross-selling insurance, pension insurance and other financial products, it should be noted. The US took action against 'red-lining' in banking through the Community Reinvestment Act (CRA), which requires banks to reinvest into communities a proportion of the deposits taken from those communities. To meet these requirements, many US banks chose to provide capital to

[12] See Collin et al, 2001; Copisarow, 2005; Mayo et al, 1998.

[13] The Phoenix Fund was set up in 1999 to encourage enterprise in disadvantaged communities and in groups under-represented in business ownership. It operates as a challenge fund inviting rounds of bids for development capital from CDFIs. For further information on this and on Community Investment Tax Relief, see http://www.sbs.gov.uk.

CDFIs, rather than lend directly to the target communities. It may be that the UK (or the EU) needs its own CRA, although, if banks choose not to collect deposits from certain communities and groups, there would no need to re-invest them! The CRA itself is under threat in the US as lobbying by banks against it has intensified since George Bush and the Republicans replaced Bill Clinton's Democrats, who had reinforced the CRA during the second term of Clinton's presidency.

It should be kept in mind that the promotion of CDFIs is not the only similarity between the UK and the US financial systems: Both are prototypes of a market-based system; both have rather profitable banking systems; and both lack a strong public and/or non-profit banking sector.

Germany's system is having none of these features, which brings us back to the question: Is Britain really a good role model for Germany?

4 A good role model?

The British and German banking systems compared – stylized facts

In sum, we found important differences between the German and the British banking systems, which give rise to some doubts about the idea of Britain being a good role model for Germany in all respects:

- While non-profit players, and especially public savings banks, have a prominent role in Germany's banking system, the British banking system is dominated by for-profit players.
- While Germany's population has almost unrestricted access to banking services and SMEs are mainly served by the non-profit players, there seem to be fairly widespread problems of access to even the most basic banking services in Britain.
- Germany has many more retail banks and branches, whereas the UK arguably has too few branches.
- The German payments system is efficient and easy to use and there is little evidence of cross-subsidisation or financial exclusion, at least to the extent that there are very few people who cannot open bank accounts at a local bank, the Postbank provides a backstop and there are few complaints about exclusive bank charges.
- Germany's banks are among the least profitable in Europe. Within the German system, the savings banks and co-operative banks are not the worst performers, however. The competitive privileges of the non-profit players that still exist in Germany may play a role here. In contrast, British banks have been very profitable in recent years, but there are strong indications that some of the profitability of British banks is a result of their exploiting 'complex monopoly' power. Furthermore, the 'cost efficiency' in British banking results in problems of financial access for low-income households, leaving it open as to who is supposed to perform the public and social duties that are performed by public and co-operative banks in Germany.
- The problem of over-indebtedness also seems to be more pronounced in Britain than in Germany, owing to, inter alia, aggressive lending by credit-card issuers, and SME use of credit cards is growing (*Financial Times*, 17/8/05, p 3).
- Furthermore, in the UK, there are initiatives to reintroduce social banking, which had almost vanished from the financial market a decade ago.

The contrast between Germany and the UK is thus marked.

In sum, in the UK, there is evidence of financial exclusion. Poorer clients generally pay more for banking (and insurance) services than richer clients because of cross-subsidisation, and there is widespread over-indebtedness, and thus overlending, for which the financial sector bears part of the blame. In addition, there is evidence of overcharging of credit-card users and SMEs by banks, and cross-subsidisation in the payments sector. Poorer clients and SME customers seem to be better off in Germany's banking system, but does this give a sound argument to reject the idea of the need for reform in Germany and to keep the German banking system as it is? Some aspects shall be discussed in more depth in the following paragraphs.

Underbanking in the UK versus overbanking in Germany

The UK is arguably underbanked in the sense that there is evidence of financial exclusion, and branches generating insufficient profits have been closed, or will be closed when the opportunity arises. It has been suggested that banks may be implicitly adopting a policy of agreeing to share out closures while keeping the last branch in town open.

Does this mean Germany has too many banks, or branches? Certainly, there are a large number of banks, but the savings and co-operative banks, combined with their central institutions, can arguably be regarded as single entities and should be encouraged to operate as such, thereby sharing and exchanging portfolio risks in order to avoid local over-concentrations of lending. They operate their own mutual guarantee schemes under which stronger banks routinely absorb weaker ones, and this has already led to a reduction in the number of individual banks in the recent decade or so of slower growth. Whether there are too many branches is more difficult to determine, although the number is inflated compared to the UK by the inclusion of Post Office branches. Access to finance is good, and the big four German private banks do not maintain such a widespread network as the non-profit players do. It is reasonable to assume that the non-profit players would turn to cost-cutting by branch closures if their mission were changed to a for-profit one.

There seems to be no compelling reason, however, to change the law to allow the shareholders of German 'private banks', which control such a small proportion of the retail banking market, to take over the *Sparkassen* in order to create a UK-style oligopoly with the goals of gaining monopolistic rents and to further boost dividend payments by engaging in widespread, cost-cutting branch closures. This might be the case if the retail banking services provided by the *Sparkassen* were inefficient, but there seems little evidence of that. If the *Sparkassen* abandoned their social mission, excluded more clients and closed remote branches, then maybe they too could cut costs, but the payments and other services are efficiently provided and the fees charged are not high. Interest paid on savings balances is low, but that is largely because the European Central Bank (ECB) sets the benchmark rate, which itself is currently low. It should be noted that the large UK retail banks do not pay generous explicit (as opposed to implicit) interest rates anyway, despite the higher interest rates set by the Bank of England compared to the ECB.

Furthermore, once competition is eroded, as in the UK, it is difficult to reintroduce it by regulatory fiat because of 'switching costs' (Gondat-Lorralde and Nier, 2004). In response to the Cruickshank Report (2000), the government requested a review of the (voluntary) Banking Code, which led to a recommendation (Julius Report, 2001), which was subsequently implemented, to make it easier for households (and small businesses, following the Competition Commission Report; see Bank of England, 2002) to switch accounts. The Financial Services Authority has also been attempting to raise consumer awareness of the potential benefits of changing bankers. The 'switching costs', which may include a lost relationship built up over time, may well be perceived to be higher by SMEs than by consumers (Bank of England, 2004). Heffernan (2005) also finds evidence that is strongly suggestive of significant switching costs, imperfect information and inertia in the SME banking market.

If there really is a need to increase concentration in German banking in order to reap efficiency gains through economies of scale and scope (rather than a political means of creating a 'national champion'), then mergers among the 'private' banks and/or with the Postbank, allowing increased nationwide competition via its branch network, would seem the best route. Furthermore, there seems to be some reason to question whether the central institutes of the savings bank sector, the *Landesbanken*, still serve a function in the German market. On average, the *Landesbanken* do not perform as well as the primary savings banks, and they serve clients who could just as well be served by the for-profit market players. Some consolidation and privatisation among the *Landesbanken* might therefore be desirable. Alternatively, they could be integrated more closely with the *Sparkassen*.

It needs to be stressed, however, that these are only tentative and very preliminary results. Nonetheless, they point in a similar direction to that of recent research, which revives the discussion about the role of non-profit players and public banks in the financial markets. While a few years ago the guiding principles of financial architecture denied any direct role of the state in commercial banking, the recent literature[14] is much more ambivalent. There might be a role for public involvement in the supply of banking services, depending on the circumstances and the legal framework. Furthermore, private non-profit structures might have advantages over for-profit ones in certain markets. Britain and the US seem to have re-discovered this in their initiatives to encourage non-profit providers of loans, such as CDFIs. This does not mean, however, that there is no need for reform in Germany.

Too little lending to MSEs, or too much?

There also remains an issue as to whether there is overbanking, in the sense of too much lending to MSEs in Germany.[15] In the UK, it is possible to argue that it is only micro enterprises in deprived communities that face credit rationing. Other SMEs and medium-sized companies seem to have reasonable access to loans and, in the case of some of the larger ones, private equity finance, with medium-sized companies also having access to below investment grade, or 'junk' bond markets. If there is too little corporate lending in the UK, the very small and micro enterprises are suffering. Considering the differences between Germany and Britain, we should expect to find less evidence of financial exclusion of this client group in Germany and little need to create new institutions such as the UK's CDFIs.

It was therefore somewhat a surprise for us to find that in Germany a Microfinance Institute, the Deutsches Mikrofinanz Institut (DMI), had been recently established. It was

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[14] See, for example, Levy-Yeyati et al, 2004; Micco et al, 2004.

[15] In contrast to Stiglitz (1981), de Meza (2002) considers the general possibility that asymmetric information may lead to overlending, rather than credit rationing.

set up by the Gemeinschaftsbank für Leihen und Schenken (GLS), the Community Bank for Loans and Gifts, and regional entrepreneurial advisory centres with the aim to support the development of micro enterprises in Germany. The Institute wants to initiate the testing and adaptation of microfinance methods to the German environment.

The DMI organises and provides the necessary resources for micro loan disbursement, and it supports and creates co-operation between the regional advisory centres on the one side and private and governance funds for small business development, local public and co-operative banks on the other. In a first round in June 2005, five advisory centres were selected in Germany, which from then on were able to give loans to their customers in co-operation with a regional bank. The loans are collateralised by a guarantee of the GLS' own microfinance funds. Primarily driven by a social and idealistic mission, the DMI initiative represents a pilot project to test the viability of micro lending in Germany, which is viewed as a presumably promising way out of the German unemployment problem (see http://www.mikrofinanz.net).

Furthermore, Kreditanstalt fûr Wiederaufbau (KfW), the German government development bank, established a microfinance programme for Germany in April 2004 alongside its traditional SME lending promotion activity (discussed in Mullineux, 1992, 1994), now organised under the roof of KfW's '*Mittelstandsbank*'. The *Mittelstand* programme, however, is extensively used already by the *Sparkassen* and the co-operative banks to support MSE lending activity. From our interviews, we gained the impression that the new microfinance programme is politically driven. The programme is supposed to encourage job creation via micro enterprise formation in Eastern Germany. It seems doubtful, however, whether the programme will have any more than a public relations effect. The design of the programme gives good reasons to expect that it will be unattractive for the target group because the interest rates for these micro loans are too high in comparison with other promotional loan schemes, which offer higher volumes as well. Hence, it seems very unlikely that the micro loan scheme represents an attractive new option for new entrepreneurs with viable business plans.

Based on our preliminary research results, the need for increased access to microfinance in Germany as a whole, and in Eastern Germany in particular, has yet to be confirmed. There might well be a possibility that the various schemes aimed at stimulating lending to SMEs by providing co-financing and loan guarantees, which are widely used by the *Sparkassen* and the co-operative banks, lead to too much credit being supplied; in the sense that significantly less credit would be provided at market risk-related rates if the implicit and explicit subsidies were removed.

The social and economic benefits of such an arrangement need to be carefully weighed. Self-employed people do not (legally) draw unemployment benefits, for example, and they gain skills through working. Against this, overgenerous unemployment benefits may discourage enterprise formation if the curtailment of benefits is too sharp. Furthermore, high labour costs may discourage expansion and help explain why family businesses (in which 'sweat equity' can be freely invested) are regarded, according to our interviews, as the most likely to succeed, especially among start-ups and early growth firms.

The underlending (in the UK) to MSEs versus overlending (in Germany) issue is thus a promising area for further research, especially as it is difficult to draw a clear line between consumer and corporate lending if MSEs are concerned. Overlending in Germany and underlending in the UK by the banking sector could well go along with the opposite phenomenon in UK consumer lending. The question of the optimal mix of MSE finance and subsidies or guarantees in industrial countries is still unanswered.

Bank versus equity finance

Despite our doubts as to whether Germany should radically reform its non-profit banking sector, the perception of critics of the German financial system, who demand a better access to equity finance, should be taken very seriously. It might be worthwhile for financial sector reformers in Germany to focus on the proposals of the Initiative Finanzstandort Deutschland (2005). These proposals are widely supported and focus on finding means of accelerating the development of the private equity markets in Germany in order to reduce reliance of the *Mittelstand*, and especially middle-sized private, and often family shareholder-dominated, companies, on banks; or, rather, to increase the menu of financial options open to them. For this to succeed, private investors and venture funds need an 'exit' – i.e. to be able to sell the private company to public shareholders via an initial public offering (IPO) in order to liquidate their funds for subsequent re-investment in other ventures. A number of the *Mittelstand* face 'succession problems' where the entrepreneurs who established them are also seeking to exit. To facilitate exit, a thriving junior market, such as the Alternative Investment Market (AIM) in London, is required. Germany's last attempt at establishing such a market, the '*Neue Markt*', failed following the collapse of the dot-com bubble. There may well be lessons to learn from London, however, where AIM was formed to replace struggling second- and third- level stock markets, and there are now signs that the Deutsche Börse is planning to reintroduce a junior market by adding an 'Entry Standard' segment to its regulated unofficial ('open') market.

Accordingly, Germany may still be overbanked, but not in the sense of having too many banks or bank branches. It may instead be over-reliant on bank finance. It is natural for micro and small enterprises to be bank-dependent owing to information asymmetry (see Bernarke and Gertler [1995], for example), but this is not so for the middle-sized companies among Germany's *Mittelstand*. It is, however, not so much the banking sector that needs reform, but rather stimulus needs to be given to the development of private equity and venture (and hedge) funds, and fear of (foreign) 'locusts' needs to be overcome. The big four 'private' banks are natural players in these markets. The *Sparkassen* are unlikely to engage, and can instead continue to focus on MSE lending. They might profit from a development of capital markets indirectly, however, in the form of better opportunities to securitise parts of their credit portfolios once they have utilised the still unexhausted capacity for internal credit-risk transfers within the savings bank system.

Nonetheless, when calling for the development of German capital (and especially equity) markets, it needs to be taken into account that the different building blocks of a financial system are not totally independent. To be able to develop capital markets, it might well be necessary to initiate reforms in complementary areas, such as the legal framework and the government structure, which will not leave the banking system totally unaffected. To give just one example: introducing more transparency and strengthening shareholder rights, which will give a positive impulse for the development of equity markets, will at the same time weaken the traditionally very strong position of creditors in the German financial system. German banks will have to adapt their credit policies. Relationship banking might well be replaced by more transaction-based lending, at least with those customers who are in the comfortable position of being able to choose between alternative financing sources.

Needless to say, more research is needed before a satisfactory answer about the most promising way to restructure a financial system can be given. Eliminating shortcomings while preserving traditional strengths might not be an easy task because complex trade-offs are involved in financial sector design.

Oversaving versus overconsumption

Another area of relevance to the debate is the argument that the German economy has grown more slowly than the UK one owing to oversaving and underconsumption. In contrast, it is just as easy to argue that the UK has been undersaving and overborrowing to fund overconsumption, so that the higher growth rate is unsustainable. Indeed, in the second half of 2005, there was emerging evidence of an economic slowdown in the UK.

UK under-saving is particularly marked in the light of the inability of long-term savings, especially among people on middle and low incomes, to fund pensions sufficient for a comfortable retirement. German savings levels may therefore prove to be no more than what is prudently necessary to fund a good retirement income (and thus long-term consumption close to current levels) and adequate nursing care in old age. However, the Initiative Finanzstandort Deutschland has proposals involving the stimulation of the development of funded pension schemes, and concomitantly the capital markets, in order to provide a greater return to savers, perhaps releasing more money for current consumption. Meanwhile, private-sector pension provision in the UK, until relatively recently held up as an example for the rest of the EU, is under government-level review following the revelation of serious shortcomings in recent years.

It is beyond the scope of our research to go deeper into these problems of the optimal mix of pension schemes. We did not want to miss the opportunity, however, to at least mention the interlinkage between this important topic and our topic of financial system reform.

Conclusion

Comparing the banking systems of the UK and Germany with a special focus on the supply of financial services to small entrepreneurial clients and low-income households has revealed marked contrasts. In addition to those differences between bank-dominated and market-based financial systems, which have been extensively discussed in the literature, our research revealed remarkable differences in the provision of services to the low-income end of the financial market. In our view, the most important output of our research is a clearer picture of those problems in MSE financing and the supply of financial services to low-income groups, which are still unresolved:

- What is the role of public banks in serving the MSE and low-income household target groups?
- Are there viable private non-profit alternatives to public sector banks?
- What is the exact nature of the interaction between the supply of corporate finance and consumer finance by banks and other financial and non-financial firms?
- How is the problem of over-indebtedness, which is linked to the access to finance, responsible lending and cross-subsidisation issues, to be tackled?
- Does governmental support for lending to MSEs in industrial countries make a positive contribution to solving economic problems, or is it an activity which has to be classified as purely socially motivated?
- How does financial sector restructuring in favour of the target groups of MSEs and low-income households:
  - i. affect the financial system as a whole; and
  - ii. interact with the framework of the social security system?

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Appendix

Abbreviated Interim Report on Project No: 1488 'UK banking: Is it really a good model for Germany?'

Professor Eva Terberger (Department of Economics, University of Heidelberg) visited Professor Andy Mullineux (Business School, University of Birmingham) during the week beginning 31 January 2005 to discuss the project. They agreed to focus their study by considering the question 'Micro and small enterprise financing: too little versus too much?'. It was agreed that Andy should visit Heidelberg in July 2005, after the end of the teaching period there, in order to interview various public and private banks inter alia concerning the role of savings banks in MSE financing and the availability of government-sponsored support for MSE financing in Germany.

Prior to Eva's visit, Andy attended conferences on Access to Finance, organised by the World Savings Bank Institute (28 and 29 October 2004) and (by invitation) on microfinance organised by the European Commission (21 September 2004). During a previous visit to Brussels (2 September 2004), Andy took the opportunity to visit the offices of the World and European Savings Bank Institute where they arranged for him to interview Wolfgang Neumann, Deputy Head of the *Deutscher Sparkassen-und Giroverband* (DSGV) Representation to the EU, to discuss the role of savings banks in Germany.

In preparation for the Brussels meeting, Andy had undertaken desk research during the Autumn Term 2004 relating to the UK banking model, and this too was discussed with Wolfgang Neumann. Subsequently, Wolfgang Neumann asked Andy if he would talk to Henriette Keller, a part-time PhD student working on UK banking under Professor Uwe Schneider at Darmstadt University, about her thesis. They met on 21 April 2005 in Birmingham. In addition, Wolfgang Neumann sent Andy two useful papers outlining the savings banks' (*Sparkassen*) position on the proposed restructuring of the German banking system.

In early July 2005, Andy attended the annual CDFA conference in Melton Mowbray, where he caught up with the latest developments of MSE financing in the UK, made some helpful contacts and gathered some useful literature.

Andy visited Eva Terberger and her new PhD student, Jan Schrader, who is working on the new microfinance initiatives in Germany, during the week beginning 11 July 2005.

Flying via Frankfurt on 11 July, Andy took the opportunity to conduct interviews with Dr Carl-Christoph Hedrich (Senior Vice-President, Head of Financial Markets Analysis) and Patrick Panther at the Commerzbank head offices. They provided an extremely useful briefing on the 'private' bank perspective of the role of *Sparkassen* and *Landesbanken* in Germany.

Andy subsequently had a lunchtime meeting with Dr Darkwart Plattner (Senior Economist) and Dr Phillipp Tillessen (Economic Research) at the KfW, who explained the various programmes operated by the KfW in support of SME financing, including the KfW's new microfinance programme for Germany.

On Tuesday 12 July, Andy, Eva and Jan returned to Frankfurt to meet Michael Roth of Deutsche Gessellschaft für Technische Zusammenarbeit (GTZ), which had been engaged by the DMI new German Microfinance Institute, sponsored by one of the central institutions of the co-operative bank network, to undertake research into the potential market for and impact of microfinance in Germany. Michael Roth was able to supply them with useful information relating to their research findings to date, and Andy was able, in exchange, to provide an outline of microfinance (community development finance) developments in the UK, having recently attended the CDFA conference in Melton Mowbray the week before.

On Wednesday 20 July, Andy, Eva and Jan visited the head office of Heidelberg *Sparkassen*, where Thomas Lorenz (Manager) and Sibylle Beiter (International Business) spoke to them. They provided useful information and background figures on the roles of 'private banks', *Sparkassen* and co-operative banks in MSE financing in Germany.

On Friday 22 July, Andy travelled back to Birmingham via Frankfurt where he had a lunchtime meeting with Henriette Keller and Uwe Schnieder, during which he was able to answer numerous questions concerning the UK banking market, and in turn to clarify a number of issues relating to the German banking market. They agreed to keep in touch, exchange papers and answer further questions.

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